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Life Insurance

Purposes and Basic Policies

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We all must face the inevitability of death and the economic hardship that others might face when we die. Buying life insurance is one way to ease the burden of that economic risk. We can protect surviving family members by paying a relatively small amount, called the premium, to an insurance company. Then, the insurance company will pay a relatively large sum of money to the beneficiaries of the policy when the insured person dies.

In other words, the risk of a large financial loss that may result from the death of an individual can be transferred to the insuring organization — the insurance company. Life insurance is a means of providing an instant estate for the survivors at the death of an insured person. While the basic concept of insurance is quite simple, many of the details of life insurance can seem complex.

Protection with life insurance

Because families depend on cash for day-to-day survival, there is a real need for protection from financial disaster if the source of cash is removed. Life insurance is one way to provide security if part or all of the family's income is cut off because of death. It can also provide funds to replace the services that a member of the family provides — child care, for example.

Protection and savings?

The major purpose of life insurance is protection — the instant estate to meet survivor needs. Some policies include a savings feature, but there are many other ways to save money and make investments. When buying life insurance, your primary concern should be providing adequate protection; the possible savings feature is a secondary consideration.

Even when protection needs have been met, it is a good practice to consider other forms of saving and investment plans for a family. Whether to save or invest through life insurance or other saving or investment media is a family choice, based on needs, preferences, and ability to manage finances. It is a saving/investment decision, not an insurance decision.

You may get a better return on your money through other saving or investment vehicles. In addition, a variety of saving and investment opportunities are available that do not require paying any commission, or require a commission that is lower than that for saving through life insurance.

Earnings on the saving or investment element of life insurance are tax-deferred; but there are a variety of other saving/investment media that also provide deferral of taxes on earnings. However, earnings in a life insurance policy that are part of the proceeds paid to a beneficiary after the death of the insured are not subject to income tax at all.

Assessing needs

Families should consider total financial needs and other resources available when determining their need for life insurance. Needs depend upon:

- The number and ages of dependents (wife, children, parents, etc.);
- The standard of living desired for dependents if the income earner should die;
- The amount of other financial resources a family has (Social Security, savings, investments, dependents' earning capacity, etc.).

Considerations when buying

The financial needs of surviving family members may include:

- Expenses in connection with the death (funeral expenses, final medical expenses not covered by health insurance, expenses for estate settlement, and possibly readjustment expenses such as relocation of the family, etc.)

- Day-to-day living expenses of surviving dependents (food, clothing, etc.).
- Payments on debts (a mortgaged home or farm debt, car loan, etc.).
- Special needs (securing a loan, assuring children's educational expenses, gifts to family, friends or organizations).
- Retirement income for the surviving spouse, and perhaps for other dependents.
- (See MU publication, GH 3421, *Determining Life Insurance Needs.*)

Principles for buying

- When buying life insurance, a family should develop a plan and select policies that fit their particular financial needs. They should use life insurance to provide for financial needs that are not met in other ways.
- This plan should fit the family's ability to pay for the insurance, because premiums must be paid to keep the insurance in force.
- A family should select the premium period that provides the most economical rate (usually annually). This takes planning and must be included as an item in the monthly budget.
- Families should read each policy carefully. Policy owners should assure themselves they are making the best use of their insurance dollars for the financial security of survivors of the insured person.
- The family insurance program should be reviewed periodically and revised to meet changing needs.

Basic policies: pure protection (term) and cash value

Term insurance

Term insurance is a type of life insurance that provides pure protection only. It insures an individual against the risk of financial loss in case of death. It does not include a savings plan; it is strictly an insurance protection contract, similar to auto, home, or health insurance. The owner buys a certain amount of coverage and pays an annual premium based on the insured's age. As the name suggests, this policy covers the insured for a certain term or period of time. At the end of the term, the coverage stops, unless the policy is renewed. The simplest form of life insurance protection is annually renewable term insurance. The owner of a term life insurance policy can continue protection for additional terms, but as he or she grows older, the premium per unit ($1,000) of coverage will increase for each new term.

Some term policies are for five, ten or twenty years. The annual premium remains the same over the term. It is also possible to buy a term policy that will cover the insured for the same annual premium from the time of the purchase to age 65. The actual cost of protection increases each year, but this cost is averaged out to provide a level premium during the term of the policy. This is known as level premium term insurance.

Another form of term insurance is **decreasing term**. In this form, the amount of protection declines as the insured grows older, so the annual premium can stay level.

Because term insurance provides pure protection, it provides the most coverage for the premium dollar spent.

Cash value insurance

Cash value life insurance policies consist of two elements — a decreasing amount of actual insurance protection over time, combined with a savings component that increases over time — which is funded by premium payments and earnings on the saving element in the policy (see Figures 1 and 2).

There are two basic types of cash value life insurance policies. They are designed to provide coverage throughout life (whole life policies) — straight life and limited payment.

Straight life insurance

This policy provides a certain amount of coverage throughout life. It combines a decreasing amount of protection with an increasing amount of savings. But the total coverage provided by the policy (the face value of the policy) — including both the protection and the savings elements — remains the same.

Because the owner is building up

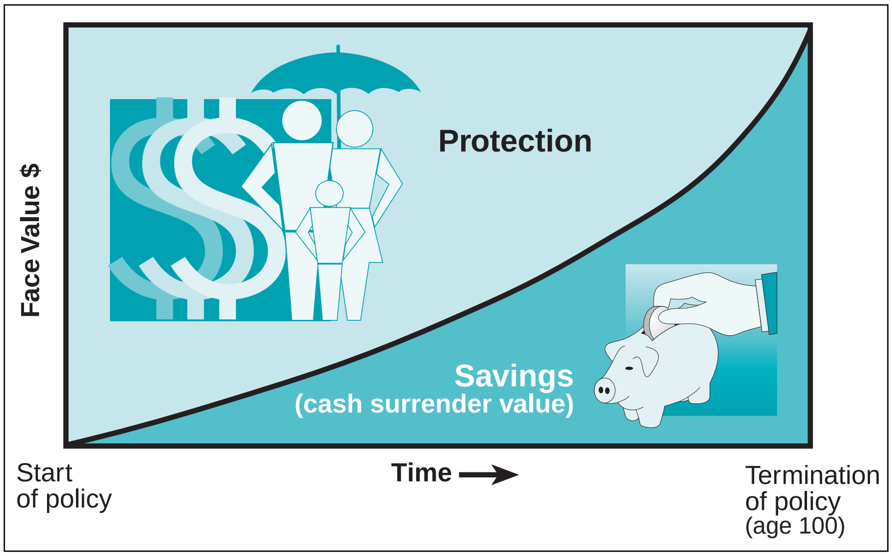

Figure 1. Straight life policy.

savings as well as buying protection through this plan, the premium is higher than the premium for term insurance. As with all life insurance policies, the premium is based on the age of the insured when the policy is purchased. The premium for straight life insurance then remains the same through the life of the policy. This is because the policyholder is paying more than the cost of pure protection during the early years of the policy. The excess portion of the premiums, above the cost of pure protection, is what builds up the savings element of the policy. Because the protection element decreases over time as the savings element increases, the level premium continues to be adequate to cover the cost of the policy as the insured grows older.

The face value is the amount payable at the death of the insured. It includes both the protection and the savings value of the policy, if there is any. The cash surrender value is the amount of savings that has built up within the policy. This amount increases during the time the policy is in force. The insured may redeem the policy for its cash value at any time, but this terminates the policy. Or, the insured may borrow the cash value from the company; however, this reduces the total coverage until the policy loan is repaid. Interest is charged on the loan until it is repaid.

If the insured continues premium payments to age 100, he or she has made sufficient premium payments to build up the cash value to make it equal to face value at that point. Therefore, as of that date, the policy consists entirely of the savings element, and there is no actual insurance protection component remaining. As with a savings account in a bank or elsewhere, the insured can at that point collect the face value of the policy while he/she is alive, because the entire policy value now consists of his/her savings element.

Limited payment life insurance

This policy is similar to the straight life policy, except that the policyholder pays the total premiums on the policy in a limited number of years, usually 20 to 30, or by age 65. After that, the policy remains in force for the rest of the insured's life unless the cash value is withdrawn, at which time coverage stops.

The premium on limited payment life insurance is higher than for a straight life policy because you pay all the premiums into the policy in a given number of years. This means the policyholder is actually building up saving (cash value) within the policy at a considerably faster rate than would be true with the straight life insurance policy, and thus reducing the protection element in the policy faster.

This policy has limited use except for families that have very high incomes in their early years (for example, a professional athlete whose income may be decreased in later years). The typical family has more stress on its budget in the early years and, because of the higher premiums, will probably find it impossible to afford sufficient coverage with limited payment life insurance. And having enough protection to provide for determined needs in event of death of the insured is the most important consideration in buying life insurance.

The price per $1,000 of actual life insurance protection rises as the insured gets older, in a cash value type policy as in a term policy. In a cash value policy, the increasing cost of protection is not obvious, because as the savings component created by the higher premium increases, the amount of the actual insurance protection component decreases.

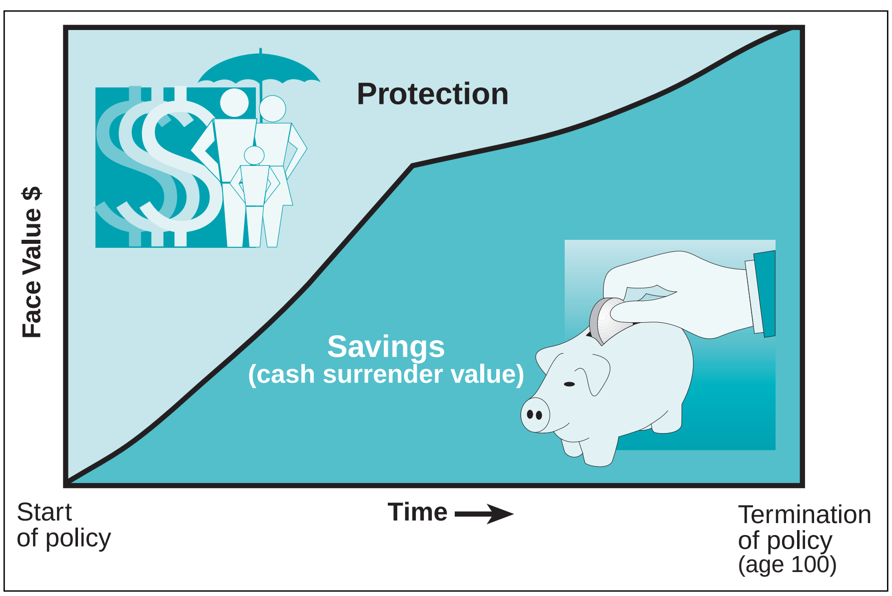

Figure 2. Limited payment policy.

Tax treatment

Cash value policies are frequently marketed as a tax sheltered form of saving. While this is a consideration, the advantages of the tax shelter are frequently overstated. The shelter of a cash value policy is that the interest earned on the cash value (savings portion) is tax-deferred as long as the policy is in force. If the policy is surrendered to obtain the cash value, income tax is paid only on the portion of the cash value that exceeds the total premiums paid on that policy. And, as noted above, if the face value of the policy is paid to a beneficiary at death of the insured, the earnings on the savings element are not taxed at all.

The tax treatment, however, is a minor factor to consider when determining the type of insurance to purchase. It is a far less important consideration than the protection provided by the policy (the instant estate created at death of the insured).

Policy selection considerations

Cash value life insurance is often promoted as an avenue for saving because the premium payments include a saving element. However, there are several factors and hazards that must be taken into account when considering cash value policies. The first, and most important, is that families sometimes purchase higher-premium policies with a savings element and provide inadequate protection to meet their needs. So if the insured dies, they have spent their premium dollars on too little protection and their financial needs are not adequately covered. A second factor is that when families commit to high-premium policies, if they face increased living expenses or a financial emergency, the insurance premiums may put too much stress on their income, and they drop the pollicy — thus leaving them without life insurance. In this case, they are not only without protection, but have a further loss because of the higher commissions paid to acquire this type of policy. Finally, if the family considers a cash value life insurance policy as a saving medium, it should compare the rate of return earned on the saving element, the commission to acquire the policy, and other factors, with alternative avenues for saving and investing.

It is important to keep in mind that there are a variety of media for saving, but the protection feature of life insurance is the only medium for creating an instant estate at the death of the insured. If a man age 25 saves $150 one day and dies the next, that $150 will be part of his estate. But if he is in good health, for that $150 he can purchase a one-year renewable term life insurance policy that will provide about $100,000 to his beneficiaries or estate if he dies the next day. This illustrates the instant estate concept, and the difference between a savings plan, in which the principal is yours whether you live or die, and an insurance protection plan, in which you are paying a modest-size premium to provide a large dollar amount of protection which will be paid only in event of your death. The protection concept is similar to the insurance you buy for a defined time period to cover your home or automobile.

Life insurance provides financial protection for survivors of the insured, and may meet other financial objectives, as well (a gift to charity, for example). Families should review their life insurance program and policies regularly and make adjustments to meet changes in circumstances and needs.

Definition of terms

Beneficiary. The person named in the policy to receive the insurance proceeds at the death of the insured.

Cash surrender value. The amount of money payable to a policyholder who purchased insurance with a savings element in it, when he or she stops paying premiums before the maturity date of the policy.

Face value. The amount stated on the face of the policy that will be paid in case of death of the insured or at the maturity of the contract. Dividend additions or additional amounts payable under accidental death or other special provisions are above the face value.

Insured. The person on whose life an insurance policy is issued.

Life insurance. A risk-sharing plan to cover the financial loss, and other financial needs, experienced by dependents upon the death of an individual.

Limited payment life insurance. Whole life insurance on which premiums are payable for a specified number of years or until death if death occurs before the end of the specified period.

Policy. The printed document stating terms of the insurance contract issued to the policyholder by the company.

Policy loan. A loan made by an insurance company to a policyholder on the security of the policy's cash value.

Premium. The payment, or a periodic payment, a policyholder makes for an insurance policy.

Straight life insurance. Whole life insurance on which premiums are payable for the life of the insured, at whose death the face value is paid to the dependents.

Term insurance. Insurance payable to a beneficiary at the death of the insured while the policy is in force.

There are numerous variations, riders, provisions and options to these basic policies. For a brief overview of the most common , refer to MU publication GH 3426, *Life Insurance: Policy Variations, Riders, Provisions and Options.*

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